Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Corbett	Analyst:	Marion Mann DeJong	Bill Number:	AB 2xx
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	05/15/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Excess Gross Receipts from Electrical Energy Distribution Tax

SUMMARY

This bill would:

- Impose a tax on excess gross receipts from electrical energy distribution (excess tax), and
- Require purchasers of electricity to withhold and remit 100% of the excess tax.

PURPOSE OF THE BILL

The purpose of this bill appears to be to respond to perceived manipulation of the electricity market to increase prices by companies that generate or sell electricity.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that the excess tax would be operative for each calendar quarter beginning on or after January 1, 2001, and before January 1, 2006. The withholding provisions would be operative for the first calendar quarter beginning after the bill becomes effective.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve implementation concerns. See "Implementation Considerations" below. Department staff is available to assist the author with amendments.

ANALYSIS

BACKGROUND

Nexus is a constitutional requirement that must be satisfied before a state can properly exercise its power to tax. It is established by a level of presence or activity within a state that is sufficient to establish a connection between the state and a business entity that allows the state, under the U.S. Constitution, to exercise jurisdiction over the business and impose a tax.

Board Position:			Department Director	Date
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Nexus is most clearly established if an out-of-state business maintains a physical presence within the state, like a sales, service, or administrative office.

Nexus requires some degree of presence within the state. The degree of presence necessary to create nexus is a matter often litigated before the courts. Solicitation of orders from outside the state by mail order, telephone, or other electronic media with delivery made by common carrier generally has been ruled to be insufficient to establish nexus. Under virtually identical facts, but with instate delivery of the product made by the business in its own capacity, nexus is established.

In the past, the concept of nexus has focused on a business' physical contacts or presence in the taxing state. This focus may be outmoded and may be shifting to include a less explicit economic standard based on a regular and systematic exploitation of the taxing state's market by a business. As technological developments change the manner in which business is conducted, a company that uses electronic technology (e.g., toll-free telephone numbers, telemarketing, computer services, etc.) may have no less a "presence" in a state than a business that establishes a physical presence. Both businesses are cultivating the state's market and are enjoying the protection and services offered by the state for which the state deserves a return.

The inherent jurisdiction of states to tax is limited by the U.S. Constitution under the Commerce and Due Process Clauses. The Commerce Clause of the U.S. Constitution prohibits the states from inhibiting or placing an undue burden on the free flow of interstate commerce. Income from business activities constituting purely interstate commerce may be taxed by a state provided the tax is not discriminatory and is properly apportioned to a specific local activity. In other words, a state may tax exclusively interstate commerce as long as the tax does not create an effect proscribed by the Commerce Clause.

The Due Process Clause of the Fourteenth Amendment prevents a state from imposing a tax on a person over whom it has no jurisdiction and requires that the person, object, or activity subject to the tax have some relationship to a fixed position within the particular state. There must be some definite link or minimum connection between an activity within the state and the tax. The underlying question is whether the state has provided some service, protection, or facility for which a return in the form of a tax would be equitable and whether the tax imposed is a reasonable means of defraying the costs of state government. The Supreme Court has set a standard of fairness that implies that if a sufficient contact between the taxing state and the nonresident taxpayer exists, and the tax imposed is fairly related to the taxpayer's in-state business activities, the tax will pass constitutional muster. The most frequently cited description of the due process standard is found in a Supreme Court case dealing with the power of a state to impose a tax on a foreign corporation on dividend income derived from property located and business transacted in the state:

> "That test is whether property was taken without due process of law.... whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask for a return."[1]

There is no “bright line” test regarding the circumstances that cause a contact to be sufficient to subject a business to taxation by a state.

[1] *Wisconsin* v. *J.C. Penney Co.* (1940) 311 U.S. 435.

Congress further restricted the states' powers to tax even when Constitutional nexus was established by enacting Public Law (P.L.) 86-272. P.L. 86-272 prohibits states from imposing an income tax upon the income of a person derived within the state if the person's only business activity in the state is "solicitation" of orders for sales of tangible personal property. P.L. 86-272 applies where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

California's interpretation of P.L. 86-272 is summarized in the publication, "Application and Interpretation of Public Law 86-272 (FTB Pub. 1050)." The key points of this interpretation are:

1. Under P.L. 86-272, only income derived within the state from the sale of <u>tangible personal property</u> is immune from taxation. This law does not prohibit California from taxing income from selling or providing services and selling, leasing, renting, licensing or other disposition of real estate, other personal property, intangibles, or other types of property in this state.

2. The activity must be limited to <u>solicitation</u> (except as noted under #3).

3. P.L. 86-272 extends to activities performed on behalf of the person by independent contractors that do not represent a single person. Independent contractors may solicit sales, make sales, and maintain a sales office without defeating a person's immunity from income taxation. However, the independent contractor may not maintain a stock of goods on behalf of the person in California.

P.L. 86-272 was amended in 1976 to add a provision that prohibits discriminatory state taxation of out-of-state manufacturers, wholesalers, retailers, or consumers of electricity.

Under current state law it is unclear whether electricity is considered tangible personal property and thus whether P.L. 86-272 would apply to a net income tax derived from a sale of electricity. Department staff does consider electricity to be tangible personal property. However, there has been no authoritative decision on this issue in California.

<u>FEDERAL/STATE LAW</u>

Prior federal law (1980 to 1988) imposed a windfall profits tax on oil. The tax rate ranged from 15% to 70% of the difference between the market price of oil and a predetermined base price.

California has not imposed a state-level windfall profits tax.

Existing state law imposes tax on the income earned by individuals, estates, and trusts. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California. The tax for individuals is computed on a graduated scale at rates ranging from 1% to 9.3%.

Existing state law imposes a franchise tax on every corporation either qualified to do business in this state or doing business in this state (whether organized in-state or out-of-state). The franchise tax is not a tax on income. Rather, it is a tax, measured by net income, for the privilege of doing business within the state. The corporate franchise tax rate is 8.84%. The S corporation franchise tax rate is 1.5%. Taxpayers are subject to a minimum franchise tax of $800 only if it is more than their measured tax.

Existing state law also imposes a corporate income tax on corporations that are not organized in or qualified to do business in California, but are deriving income from California sources. This tax is also 8.84% and 1.5% for S corporations. However, the minimum franchise tax does not apply to corporations subject to the corporate income tax.

THIS BILL

This bill would impose an excess tax on certain sellers of electricity in California. The sellers of electricity must have nexus in California and make the first sale of electrical power for consumption in California. The tax rate would be determined by the amount that the sales price per megawatt hour (MwH) of electricity exceeds the base price, as follows:

If sales price is:	Tax Rate
More than the base price but not more than 150% of the base price	50%
More than 150% of the base price but not more than 200% of the base price	70%
More than 200% of the base price	90%

“Base price” would mean $60 per MwH of electricity sold, or any subsequent price set by the California Public Utilities Commission (CalPUC). The Franchise Tax Board (FTB) would be required to publish any revised base price. Revised base prices would become effective for the first calendar quarter beginning at least 30 days after FTB publishes the revised base price.

“Sellers of electricity” would mean a person or any other entity, that is a producer, generator, wholesaler, marketer, retailer, marketer, or other vendor of electricity sold for consumption in this state.

“Sold for consumption in this state” would mean any of the following:

- sales of electricity made directly to a purchaser in this state for that purchaser’s consumption in this state.
- sales of electricity to a retailer of electricity for resale to a purchaser in this state for that purchaser’s consumption in this state.
- sales of electricity to the State of California, to any agency of the state, or to the California Independent Systems Operator (ISO).

“Nexus” would be established if the seller of electricity meets any of the following conditions, which exceed a de minimis level of contact:

- Has a physical presence in California through the presence of one or more employees, agents, members of a commonly controlled group, or representatives or other persons acting on the seller’s behalf, whether or not characterized as an independent contractor.
- Owns, leases, or rents real or tangible property in California.
- Maintains a contractual relationship with persons in California relating to the sale, distribution, or transmission of electricity to purchasers within California.
- Regularly or systematically solicits a market for the sale or purchase of electricity for the ultimate consumption in California or otherwise purposefully avails itself of California’s electricity market.

- Directly or indirectly delivers or causes delivery of electricity to any portion of the electrical grid located within California or otherwise uses that electrical grid.
- Is a member of a unitary group for which at least one member is required to file a combined report or would be required to file if a water's-edge election were not in place.
- Conducts any other activity that is not otherwise protected under the U.S. or California Constitutions, or federal or California laws.

"Electrical grid" would mean the system of interconnected generators and power lines managed in order to dispatch generators as needed to meet the requirements of the customers connected to the grid.

A seller is required to remit 100% of the excess tax to FTB by the 15th day of the month immediately following the calendar quarter. Interest would be assessed on amounts not remitted by the due date. The seller would also be required to file a quarterly return to FTB by the 15th day of the month immediately following the calendar quarter.

For calendar quarters beginning on or after January 1, 2001, and before the date this bill becomes operative, the tax and the return are due no later than the 15th day of the first month immediately following the calendar quarter in which the bill becomes operative.

Since electricity is fungible, the bill would provide a method for sellers to determine the amount of electricity sold to a retailer that also generates its own electricity for retail. "Sales of electricity to a retailer of electricity for resale to a purchaser in this state" would be determined by multiplying the total sales made to a retailer during the calendar quarter by the greater of the following two ratios:

1. The ratio of retailer's total sales of electricity made directly to purchasers in California during the 2000 calendar year to the retailer's total sales of electricity everywhere during the 2000 calendar year. If the retailer had no sales history during the 2000 calendar year, the ratio would be zero.

2. The ratio of retailer's total sales of electricity made directly to a purchaser in California for that purchaser's consumption in California during the calendar quarter to the retailer's total sales of electricity everywhere during the calendar quarter.

Retailers would be required to provide sellers and FTB with the information needed to determine these ratios. If the information needed to determine these ratios were not available, the seller would make a tentative payment based upon the last available information. Once the retailer's information is available, the difference between the tentative payment and the tax due should be remitted to FTB no later than the 15th day of the first month following the calendar quarter in which the information becomes available.

Except for residential customers and small businesses, all purchasers of electricity for consumption in California would be required to withhold 100% of the excess tax from payments made to sellers. For purposes of determining the withholding amount, the base price would be $60 per MwH rather than the base price set by the CalPUC.

The tax would be remitted to FTB by the 15th day of the month immediately following the calendar quarter in which the tax was withheld. Every purchaser required to withhold would be liable as a withholding agent for the tax.

Interest for failure to pay tax by the due date would be assessed on the taxpayer. The taxpayer is authorized to seek reimbursement for interest paid from the withholding agent obligated to remit the withheld tax. In addition, the withholding agent would be required to file a quarterly statement to FTB showing:

- the seller's name,
- the seller's tax identification number,
- the amount of tax withheld;
- the total number and amount of MwH of electricity purchased,
- the sales price of the electricity purchased,
- the purchaser of the electricity, and
- other information FTB deems necessary.

FTB would be required to inform each seller of electricity for which the excess tax was withheld and remitted to FTB by a purchaser of (1) the amount withheld and remitted, and (2) information related to the ratios for retailers if applicable.

The amount withheld and remitted would be presumed to be the excess tax owed, unless the seller requests a refund. The seller would be required to explain the reasons and facts that demonstrate why the tax withheld and remitted did not accurately reflect the tax owed.

The base price set by the CalPUC would be presumed to represent a fair sales price reflecting the seller's cost of selling electricity plus a reasonable allowance for profit margins and maintenance and operational expenses. The seller could dispute the base price by filing a claim for refund with FTB. The claim must provide the reasons and calculations that demonstrate that the base price does not reflect the taxpayer's actual costs of selling electricity or provide for reasonable profit margins and maintenance and operational expenses.

The seller could also file a claim to dispute the ratios used to determine the amount of electricity sold to a retailer that also generates its own electricity for retail.

The CalPUC would be required to review any claim for refund and make recommendations to FTB regarding disposition of the claim. Claims for refund would be required to be filed within four years from the date the tax was required to be remitted or within one year from the date the tax was remitted, whichever period is longer.

The CalPUC, in consultation with FTB, could authorize exemptions from all or part of the excess tax for sales of electricity derived from renewable energy sources.

IMPLEMENTATION CONSIDERATIONS

Since the tax amount would be withheld and remitted quarterly to the department, the excess tax would be administered outside current income tax forms and processes. The department would need to develop new forms, programs, and operations to administer this new tax. Department staff is reviewing the bill and developing a strategy for implementation. However, withholding of taxes is currently a program administered by the Employment Development Department. EDD has ongoing business constituents that comply with employee tax withholding requirements. That department may be able to implement the provisions of this new withholding program quickly.

The following implementation concerns relating to the excess tax have been identified with this bill. Department staff is available to assist with any amendments to resolve these concerns.

- Sellers would be required to remit the excess tax for calendar quarters beginning before the bill becomes operative by the 15th day of the first month immediately following the calendar quarter in which the bill becomes operative. This would require returns to be filed prior to the enactment of the bill. For example, assume the bill was enacted on September 12, 2001. The bill specifies that the excess tax is operative for taxable years beginning on or after January 1, 2001. Thus, the tax and returns for calendar quarters beginning before September 12, 2001, would be due on April 15, 2001. It appears that the author should use "the date the bill is enacted" rather than "operative date."

  However, if the bill were amended to be "the date the bill is enacted," the deadline could be within 15 days of the enactment date (using the September 12, 2001 date from above the due date would be October 15, 2001). Department staff is concerned that forms and processes could not be developed in time to process the remittance of the excess tax. Further, it may be difficult to provide withholding agents with appropriate instructions for withholding and remitting the tax before the withholding amounts are due.

- The excess tax is imposed on gross receipts from selling electrical power that is consumed in California. Once electricity is put onto the transmission grid it may be difficult to determine where a particular watt is actually used and whether the excess tax applies. It may be difficult for taxpayers, withholding agents, and department staff to determine if a sale is for electricity consumed in California. This could result in disputes between taxpayers and the department.

- The requirement that the seller and withholding agent remit tax at the same time is problematic. Although the seller can reduce the amount they are required to remit by any amounts withheld, sellers may not know what amounts have been withheld, and may overpay the tax. FTB is required to inform sellers of amounts withheld and remitted by withholding agents. However, this information could not be sent to the seller prior to the due date since the withholding agent has the same deadline to remit the tax.

- Department staff would not know when a sale occurred to enforce withholding or collection of the tax.

- The bill requires the tax to be remitted by the 15th day of the month immediately following the calendar quarter in which the sale occurs. The bill does not specify how to treat long-term contracts where a sale occurs but payment is made over a period of time. As drafted, it appears that the tax would be imposed regardless of when payment is received.

- The bill requires every seller to "transmit" a return to FTB (page 5, line 3) in the form and manner prescribed by FTB. Generally, returns are "filed" with FTB. The term "filed" allows paper or electronic filing. The use of the term "transmit" implies that all returns must be sent electronically.

- The bill requires FTB to publish the base price set by CalPUC, however it does not specify how the rate is to be published or for how long.

- It is unclear whether corporations required to pay the excess tax would be able to claim a deduction for that tax on their corporate franchise or income tax return. Generally, corporations are not allowed a deduction for a tax on, according to, or measured by income.

TECHNICAL CONSIDERATIONS

The following technical concerns have been identified. Department staff is available to assist the author with amendments to resolve these concerns.

- An unusual phrase is used in the tax rate language on page 2, lines 15 and 16. The bill says at a rate determined by "reference to the percentage" by which the sales price exceeds the base price instead of "the amount" by which the sales price exceeds the base price.

- The language of the denominators in retailer ratios is inconsistent. The denominator of the first ratio says "to *the sum of* the retailer's total sales of electricity everywhere during the 2000 calendar year" (page 3, lines 32 and 33). The denominator of the second ratio says "to total sales of electricity everywhere during that calendar quarter" (page 4, lines 1 and 2). "The sum of" is not needed in the first denominator.

- On page 5, line 19, the word "the" should be inserted before "act."

LEGISLATIVE HISTORY

AB 128x (Corbett and Wiggins, 2001/2002) was identical to this bill. AB 128x died in the Assembly Appropriations when the first extraordinary session ended.

SB 1x and SB 1xx (Soto and Scott, 2001/2002) are identical bills that would impose an Electricity Windfall Profits Tax on sellers of electricity and refund the amount collected to individuals required to file a tax return. SB 1x died in the Assembly when the first extraordinary session ended. SB 1xx is at the Assembly desk.

SB 14 (Thompson, 1995/1996) and SB 1777 (Burton, 1999/2000) would have imposed a Petroleum Windfall Profits Tax on certain taxpayers engaged in petroleum refining. SB 14 failed passage in the Assembly Revenue and Taxation Committee. SB 1777 was held in the Senate Rules Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not have windfall profits taxes.

However, *New York* does impose a privilege tax on natural gas importers for importing or causing to be imported gas services into *New York* for their own use or consumption. This tax is gradually being phased out through rate reductions and will be totally eliminated by January 1, 2005.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

The department's costs to administer this bill cannot be completely determined until implementation concerns have been resolved. However, department staff anticipates that the bill would need to be amended to add supplemental appropriations for FTB's fiscal year 2000-01 budget and to appropriate funds for FTB's fiscal year 2001-02 budget to administer this bill. It is estimated that costs would range from $5.4 million to $6.1 million.

ECONOMIC IMPACT

Revenue Estimate

Based on limited information and the discussion below, it is estimated that the excess tax could range from hundreds of millions of dollars to as much as $2 billion in the first year. As explained below, the majority of revenue generated as a result of this bill would primarily affect energy sales that transpire prior to the enactment of this bill and before market participants could change their trading patterns and behavior as a result of this bill becoming law.

Revenue Discussion

Developing estimates of this sort is very speculative due to inherent uncertainties, such as, limited information regarding the sale of electricity for consumption in California, predicting future sale prices for electricity in California and changes to the base price by the CalPUC. Also the number and dollar amounts of potential refund claims, exemptions authorized, trading patterns, and behavior change of market participates are uncertain.

Industry experts estimate that during the first four months of the year (2001), California paid approximately $2.5 billion in excess profits for the purchase of electricity. Of this amount, it is unknown how much of the estimated excess profits would be subject to the excess tax. It is staff's understanding that the majority of energy sales made to California were sold through middlemen and not directly from the generators and in some cases electricity was traded over and over again, before finally being sold to California for consumption. Therefore, it is unknown if the final sales price to California represented sellers' cost plus "reasonable profit," which would exclude the seller from the excess tax.

In consulting with market experts who analyze behavior of market participants, it is anticipated that the majority of traders will change their behavior by; 1) charging rates within the base price, 2) be able to fully justify any increase in production cost, which would justify sales in excess of the base price, or 3) restructure their trading patterns so as not to subject themselves to the excess tax.

In summary, it is unknown if this bill would have a significant impact on California's energy prices. However, this bill may change the way business is conducted for market participants in the energy market

LEGAL IMPACT

Some sellers of electricity that have profited from the California energy crisis may not be impacted by the excess tax because they may not have sufficient nexus in California. Companies that would be subject to the excess tax proposed by this bill may challenge the constitutionality of the nexus provisions contained in this bill. It is unknown whether the tax would withstand such constitutional challenges.

The excess tax could be considered a form of indirect price regulation. Electricity price regulation is within the jurisdiction of the Federal Energy Regulatory Commission. As a result, this tax could be viewed as preempted by federal laws or regulations, and thus unconstitutional. However, since the tax rate is less than 100%, there is less likelihood that the tax would be seen as a regulatory act, because it would not effectively place a "price cap" on the cost of electricity sold.

The excess tax could be construed to be a net income tax. If it is found to be a tax on net income and if electricity is considered to be tangible personal property, the imposition of the excess tax might be subject to P.L. 86-272. In that case, some sellers of electricity might be immune from tax.

ARGUMENTS/POLICY CONCERNS

This bill could be viewed as inequitable as it would impose an additional tax on a single industry that already is subject to state taxation to the extent of any income derived from California sources. On the other hand, this industry has been perceived as excessively driving up the cost of electricity for an excessive profit.

Although the bill would allow the base price for determining the excess tax amount to increase, the base price for determining withholding amounts is set at $60. Thus, if the base price increases, the base price used for the withholding requirements would result in over withholding of the excess tax.

LEGISLATIVE STAFF CONTACT

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